2000
(REV. 2000)

STATE OF HAWAII—DEPARTMENT OF TAXATION

INSTRUCTIONS FOR FORM N-35

HAWAII INCOME TAX RETURN FOR AN S CORPORATION

World Wide Web

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www.state.hi.us/tax

Changes to Note for 2000

The 2000 State Legislature enacted a number of provisions which may affect a corporation's income tax return. These include:

An exclusion from gross income, adjusted gross income and taxable income is provided for amounts received by a qualified high technology business as royalties and other income derived from patents, copyrights, and trade secrets owned by the qualified high technology business and developed and arising out of a qualified high technology business. Expenses related to this income are not deductible. All income received from stock acquired through stock options or warrants from a qualified high technology business by an investor who qualifies for the high technology business investment tax credit that would otherwise be taxed as ordinary income or as capital gains to those persons is exempt from taxation. "Qualified high technology business" means a business performing qualified research. "Qualified research" means the same as in section 41(d) of the Internal Revenue Code, or developing, designing, modifying, programming, and licensing computer software.

Capital loss carryover for qualifying high technology businesses is extended to 15 years.

High technology business investment tax credit. A nonrefundable income tax credit shall be allowed in an amount equal to 10% of the investment made by the taxpayer in each qualified high technology business. The credit is subject to certain qualifications and limitations. See Form N-318 for more details.

Tax credit for increasing research activities. A refundable income tax credit shall be allowed for increased research activities in the State. See Form N-318 for more details.

Tax credit for contributions to an individual development account. A nonrefundable credit for matching contributions is available. See Form N-320 for more information.

Hotel construction and remodeling tax credit. A hotel construction and remodeling tax credit is available to taxpayers subject to Hawaii's net income and transient accommodations tax laws and is deductible from the taxpayer's net income tax liability. The credit allowed is 4% of the construction or renovation costs incurred during the tax year for each qualified hotel facility located in Hawaii.

General Instructions

Caution: *The attachment of a copy of a federal S Corporation return, Form 1120S, is not acceptable as a substitute for fully completing the Hawaii S Corporation return, Form N-35.*

- A valid S corporation election for federal purposes is automatically effective for Hawaii income purposes without a separate election.
- An S corporation having income attributable to sources both within the State of Hawaii and outside the State must attribute that income according to source for shareholder reporting.
- S corporations having nonresident shareholders are required to obtain from each nonresident shareholder, and file with the Department, an agreement (Schedule NS) that the shareholder will file a Hawaii return and make timely payment of all taxes imposed with respect to the shareholder's share of the S corporation's Hawaii income. Also, the shareholder will be subject to personal jurisdiction in the State for purposes of the collection of unpaid income tax, penalties, and interest. If the corporation fails to timely file these agreements on behalf of its nonresident shareholders, the corporation is required to pay to the State, on behalf of each shareholder for whom an agreement has not been timely filed, an amount equal to the highest marginal tax rate on individuals (presently 8.75%) multiplied by the shareholder's pro rata share of the income attributable to the State. Any payments made will be considered to be a payment by the shareholder on account of the income tax imposed on the shareholder for the taxable period. These agreements are to be filed with the S corporation's annual tax return.
- S corporations having nonresident shareholders may file composite returns and make composite payments on behalf of some or all of their nonresident shareholders.

Purpose of Form

Form N-35 is used to report the income, deductions, gains, losses, etc., of an S corporation doing business in Hawaii. Do not file Form N-35 until the corporation has been notified by the Internal Revenue Service that the corporation's election to be treated as an S corporation has been accepted. If the corporation's election is not in effect for the tax year, use Form N-30, do not use Form N-35. Unless requested by the Department of Taxation, it is not necessary to submit a copy of the corporation's accepted federal Form 2553, Election by a Small Business Corporation.

Who Must File Form N-35

A corporation must file Form N-35 if it has elected, by filing federal Form 2553, to be treated as an S corporation for federal purposes, the IRS has accepted the election, and the election remains in effect. S corporations which are financial corporations subject to tax under chapter 241, Hawaii Revised Statutes, may not file Form N-35, but must file Form F-1, Franchise Tax Return.

Termination of Election

An S corporation's status as such shall remain in effect for Hawaii income tax purposes as long as the corporation's federal election remains effective. If the corporation's federal election is terminated, the corporation's S status for Hawaii purposes is also terminated.

Six-Month Automatic Extension of Time to File Corporate Return

Use **Form N-301,** Application for Automatic Extension of Time to File Corporation Income Tax Return, to apply for this 6-month extension. File Form N-301 by the regular due date of the S corporation return. Federal Form 7004, Application for Automatic Extension of Time To File Corporation Income Tax Return, may be used in lieu of Form N-301. Federal Form 7004 must be completed using amounts for Hawaii income tax purposes. Such automatic extension does not extend the time for payment of the tax. The corporation's automatic extension does not affect the due date for the filing of the shareholder's returns. The shareholders must apply for their own extensions, if needed. If a composite return is to be filed on behalf of nonresident shareholders, an extension must be obtained for this return if the return cannot be filed by the due date of the composite return.

Period to be Covered by 2000 Return

File the 2000 return for calendar year 2000 and fiscal years beginning in 2000 and ending in 2001. If the return is for a fiscal year, fill in the tax year spaces on the form.

Note: *Form N-35 for 2000 may also be used if: (1) the corporation has a tax year of less than 12 months that begins and ends in 2001 and (2) the 2001 Form N-35 is not available by the time the corporation is required to file its return. However, the corporation must show its 2001 tax year on the 2000 Form N-35 and incorporate any tax law changes that are effective for tax years beginning after December 31, 2000.*

Final Return

If the corporation ceases to exist, write "FINAL RETURN" at the top of the form. Also check box D(1) on each Schedule K-1 to indicate that it is a final Schedule K-1.

Amended Return

To correct an error in a Form N-35 already filed, file an amended Form N-35 and write "AMENDED" across the top. If the amended return results in a change to income, or a change in the distribution of any income or other information provided to shareholders, an amended Schedule K-1 (Form N-35) must also be filed with the amended Form N-35 and given to each shareholder. Check box D(2), to indicate that it is an amended Schedule K-1.

Designation of Tax Matters Person (TMP)

An S corporation may designate a shareholder as the TMP for the tax year for which the return is filed by completing the Designation of Tax Matters Person section at the bottom of page 2 of the return.

When to File and Where to File

Returns must be filed on or before the 20th day of the 4th month following the close of the taxable year with the taxation district office in which the corporation's principal place of business is located, or if there is no such place of business in Hawaii, then with the Department of Taxation, P.O. Box 3559, Honolulu, Hawaii 96811-3559. If this date falls on a Saturday, Sunday, or holiday, the due date for the return is extended to the next business day.

Hawaii has adopted the Internal Revenue Code provision to allow documents and payments delivered by a designated private delivery service to qualify for the "timely mailing treated as timely filing/paying rule." The Department of Taxation will conform to the Internal Revenue Service listing of designated private delivery service and type of delivery services qualifying for the "timely mailing treated as timely filing/paying rule." Timely filing of mail which does not bear the U.S. Post Office cancellation mark or the date recorded or marked by the designated delivery service will be determined by reference to other competent evidence.

The addresses and locations of the taxation district offices are as follows:

MAILING ADDRESSES

OAHU DISTRICT OFFICE
P.O. Box 3559
Honolulu, Hawaii 96811-3559

MAUI DISTRICT OFFICE
P.O. Box 913
Wailuku, Hawaii 96793-0913

HAWAII DISTRICT OFFICE
P.O. Box 1377
Hilo, Hawaii 96721-1377

KAUAI DISTRICT OFFICE
P.O. Box 1688
Lihue, Hawaii 96766-5688

LOCATIONS

OAHU DISTRICT OFFICE
830 Punchbowl Street
Honolulu, Hawaii 96813-5094
Telephone: (808) 587-6515 (Jan.-April 20)
(808) 587-4242
Toll Free 1-800-222-3229
TDD/TTY (808) 587-1418
1-800-887-8974

MAUI DISTRICT OFFICE
State Office Building
54 S. High Street, #208
Wailuku, Hawaii 96793-2198
Telephone: (808) 984-8500

HAWAII DISTRICT OFFICE
State Office Building
75 Aupuni Street, #101
Hilo, Hawaii 96720-4245
Telephone: (808) 974-6321

KAUAI DISTRICT OFFICE
State Office Building
3060 Eiwa Street, #105
Lihue, Hawaii 96766-1889
Telephone: (808) 274-3456

Accounting Methods

Figure ordinary income using the method of accounting regularly used in keeping the corporation's books and records. In all cases, the method adopted must clearly reflect income. (See IRC section 446).

Unless the law specifically states otherwise, a corporation may change the method of accounting used to report income in earlier years (for income as a whole or for any material item) by first filing an approved copy of **federal Form 3115,** Application for Change in Accounting Method, with the Department of Taxation.

Rounding Off to Whole-dollar Amounts

You may show the money items on the return and accompanying schedules as whole-dollar amounts. To do so, drop any amount less than 50 cents, and increase any amount from 50 cents through 99 cents to the next higher dollar.

Change in Accounting Period

To change an accounting period, see IRC Regulations section 1.442-1 and **federal Form 1128,** Application to Adopt, Change, or Retain a Tax Year.

Paying the Tax

The corporation must pay the tax due (line 27, page 1) in full on or before the 20th day of the 4th month after the end of the tax year. Amounts due on any Forms N-4 attached to the S corporation's return are also due at this time. As a reminder, extensions allowed for filing a return do NOT extend the time for paying the tax due on the return. If the corporation cannot pay the full amount that is owed, you can ask to enter a payment agreement by attaching a letter to the front of the corporation's return requesting a payment agreement, with the following information: (1) The corporation's name as stated on the tax return, (2) The corporation's Federal Employer's Identification Number (FEIN), (3) Type of tax (corporate income tax), and (4) Period or year. You should, however, still send in payments until you are notified by the Department.

Estimated Tax

If an S corporation expects to have a tax liability of $500 or more on its tax return for the year, a Declaration of Estimated Income Tax for Corporations, Form N-3, shall be filed for the corporation. Estimated payments are paid in four installments. These installments are due on or before the 20th day of the fourth, sixth, and ninth months of the tax year and on or before the 20th day of the first month following the taxable year. See the instructions for line 23b and Form N-3 for more information.

Penalty and Interest

a. A corporation that does not file its tax return by the due date, including any extensions, is subject to a penalty of 5% a month for each month, or part of a month, the return is not filed up to a maximum of 25%. (The penalty is imposed on the net amount due. See section 231-39(b)(1), HRS.)

b. A corporation that files its return on time but does not pay the tax when due is subject to a penalty of 20% if the tax is not paid within 60 days of the due date.

These penalties will not be imposed if the corporation can show that not filing or not paying was due to reasonable cause and not willful neglect.

The penalties are in addition to the interest charge imposed on unpaid tax.

Interest at the rate of 2/3 of 1% per month or part of a month shall be assessed on unpaid taxes and penalties assessed beginning with the first calendar day after the date prescribed for payments, whether or not the due date falls on a Saturday, Sunday, or legal holiday.

Net Operating Loss and Other Deductions

An S corporation may not take the deduction for net operating losses provided by IRC section 172 (see below for an exception) and the special deductions in IRC sections 241 through 250 (except IRC section 248).

The corporation's net operating loss is allowed as a deduction from the shareholder's gross income (IRC section 1366).

Corporations which were converted from C corporations to S corporations for Hawaii purposes by Act 16, SLH 1990, and which had unused unexpired net operating losses at the close of the corporation's last tax year as a C corporation, could elect before December 31, 1992, to not have the carryforwards restricted in the manner provided in section 1371(b) of the Internal Revenue Code. The election, made on a timely filed (including extensions) S corporation income tax return for the first taxable period beginning after December 31, 1989, or an amended return filed before December 31, 1992, by the attachment of a statement to the return, applies to any carryforward, not just net operating losses. A copy of the election is to be attached to the S corporation's tax return for each year to which the carryforward is taken. A net operating loss carryforward subject to this election is allowed as a deduction in computing S corporation taxable income after all other items of income and deductions have been taken into account and shall not reduce corporation taxable income below zero. The deduction for the net operating loss carryforward is to be included on Schedules K and K-1, line 10. The deduction shall be allowed only for losses related to Hawaii activities. No carryforwards subject to this election may be carried forward to a C corporation year within the meaning of Internal Revenue Code section 1371(b).

Attachments

Attach schedules in alphabetical order and other forms in numerical order.

If the corporation is filing any Forms N-4, Statement of Withholding For a Nonresident Shareholder of an S Corporation, attach these forms to the front of Form N-35 in the left margin as indicated on Form N-35.

Attach any Schedules NS at the very back of the return.

If you need more space on the forms or schedules, attach separate sheets and show the same information in the same order as on the printed forms, but show your totals on the printed forms. Please use sheets that are the same size as the forms and schedules. Attach these separate sheets after all the schedules and forms. Be sure to put the taxpayer's name and Federal Employer's Identification number on each sheet.

Signature

The return must be signed and dated by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or any other corporate officer (such as tax officer) authorized to sign.

A receiver, trustee, or assignee must sign and date any return he or she is required to file on behalf of a corporation.

If a corporate officer fills in Form N-35, the Paid Preparer's space under "Signature of Officer" should remain blank. If someone prepares Form N-35 and does not charge the corporation, that person should not sign the return. Certain others who prepare Form N-35 should not sign. For example, a regular, full-time employee of the corporation such as a clerk, secretary, etc., does not have to sign.

In general, anyone paid to prepare Form N-35 must sign the return and fill in the other blanks in the Paid Preparer's Information area of the return.

The preparer required to sign the return MUST:

- Complete the required preparer information.
- Sign, by hand, in the space provided for the preparer's signature. (Signature stamps or labels are not acceptable.)
- Give a copy of Form N-35 to the taxpayer in addition to the copy filed with the Department of Taxation.

Transfers to Corporation Controlled by Transferor

If a person acquires stock or securities of a corporation in exchange for property, and no gain or loss is recognized under IRC section 351, the transferor and transferee must attach the information required by IRC Regulations section 1.351-3.

Information Returns That May be Required

Form N-196, Hawaii Annual Information Form.

Federal Form 966, Corporation Dissolution or Liquidation.

Federal Forms 1099-DIV, INT MISC, OID, PATR and R. You may have to file these information returns to report certain dividends, interest payments, medical and health care payments, miscellaneous income, original issue discount, patronage dividends, and total distributions from profit-sharing plans, retirement plans, and individual retirement arrangements.

Use federal Form 1099-DIV to report actual dividends paid by the corporation. Only distributions from accumulated earnings and profits are classified as dividends. Do not issue federal Form 1099-DIV for dividends received by the corporation that are allocated to shareholders on line 4b of Schedule K-1 (Form N-35).

Specific Instructions

Federal Employer I.D. No. & Hawaii G.E./Use I.D. No.— Due to computerization of the income tax returns processing, these numbers MUST be shown in order for the tax returns to be properly processed.

Enter the number of Schedules NS attached to this return

Enter, in this space provided, the number of Schedules NS, Hawaii S Corporation Agreement of Nonresident Shareholder, which are attached to the return. See the instructions for Schedule NS later in these instructions for more information.

Passive Activity Limitations

See the instructions for federal Form 1120S for information regarding limitations for passive activities.

Income

Caution: *Report only trade or business activity income or loss on lines 1a through 6.* ***Do not report rental activity income or portfolio income or loss on these lines.*** *Rental activity income and expenses and portfolio income and expenses are reported separately on Schedule K.*

Refer to the instructions for federal Form 1120S for further guidance.

Note: *Do not include any income that is tax-exempt in lines 1 through 5 or any nondeductible expenses in lines 7 through 19. These income and expense items are used, however, in figuring the accumulated adjustments account and the other adjustments.*

A corporation that receives any exempt income other than interest, or holds any property or engages in an activity that produces exempt income, must attach to its return an itemized statement showing the amount of each type of exempt income and the expenses allocated to each type.

Line 1
Gross Receipts

Enter gross receipts or sales from all business operations except those you report on lines 4 and 5. For reporting advance payments, see IRC Regulations section 1.45105. To report income from long term contracts, see IRC Section 460.

Generally, the installment method cannot be used for dealer dispositions of property. See IRC section 453(l) for details and exceptions. For dealer dispositions of property before March 1, 1986, dispositions of property used or produced in the trade or business of farming, and certain dispositions of timeshares and residential lots reported under the installment method, enter on line 1a the gross profit on collections from installment sales and carry the same amount to line 3. Attach a schedule showing for the current year and 3 preceding years: (a) gross sales, (b) cost of goods sold, (c) gross profit, (d) percentage of gross profit to gross sales, (e) amount collected, and (f) gross profit on amount collected.

Amounts received by a qualified high technology business as royalties and other income derived from patents, copyrights, and trade secrets owned by the qualified high technology business and developed and arising out of a qualified high technology business are excluded from Hawaii income.

Line 2
Cost of Goods Sold

See the instructions for Schedule A.

Line 5
Other Income

Enter any other trade or business income not listed above and explain its nature on an attached schedule. Examples of other income are recoveries of bad debts deducted in earlier years under the specific charge-off method, and refunds of taxes deducted in earlier years. Do not include those items requiring separate computations by shareholders that must be reported on Schedule K. (See the instructions for Schedules K and K-1). Do not offset current year's taxes with tax refunds.

If "other income" consists of only one item, identify it by showing the account caption in parentheses on line 5. A separate schedule need not be attached to the return in this case.

Do not net any expense item (such as interest) with a similar income item. Report all trade or business expenses on lines 7 through 19.

Deductions

Limitations on Deductions

Caution: *Report only trade or business activity related expenses on lines 7 through 19.* ***Do not report rental activity expenses or expenses related to portfolio income on these lines.*** *Expenses related to rental activities and portfolio income are reported directly on Schedule K.*

Refer to federal instructions for Form 1120S for further guidance on limitations on deductions.

Line 7
Compensation of Officers

Enter on line 7 the total compensation of all officers except compensation reported elsewhere on the return, such as amounts included in cost of goods sold, elective contributions to an IRC section 401(k) cash or deferred arrangement, or amounts contributed under a salary reduction SEP agreement.

Line 8
Salaries and Wages

Enter on line 8 the amount of total salaries and wages (other than salaries and wages deducted elsewhere on the return) paid or incurred for the tax year. If the corporation is claiming the credit for the employment of vocational rehabilitation referrals, total wages paid must be reduced by the amount of the credit taken.

If a shareholder or a member of the family of one or more shareholders of the corporation renders services or furnished capital to the corporation for which reasonable compensation is not paid, the Department of Taxation may make adjustments in the items taken into account by such individuals and such shareholders as is necessary to reflect the value of such services or capital. See IRC section 1366(e).

Line 9
Repairs and Maintenance

Enter the cost of incidental repairs, such as labor and supplies, and maintenance that do not add to the value of the property or appreciably prolong its life. New buildings, machinery, or permanent improvements that increase the value of the property are not deductible. They are chargeable to capital accounts and may be depreciated or amortized.

Do not include IRC section 179 expense items. Report this amount on Schedule K, line 8, and each shareholder's share on Schedule K-1, line 8.

Line 10
Bad Debts

Enter the total debts that became worthless in whole or in part during the year, but only to the extent such debts relate to a trade or business activity.

Line 12
Taxes and Licenses

Enter taxes and licenses paid or incurred in the trade or business activities of the corporation, if not reflected in cost of goods sold. Taxes incurred in the production or collection of income, or for the management conservation, or maintenance of property held for the production of income may be considered to be deductible only under IRC section 212. These are not deductible on line 12; they are reported separately on Schedules K and K-1, line 10.

Do not deduct taxes assessed against local benefits that increase the value of the property assessed (such as for paving, etc.), Federal income taxes, estate, inheritance, legacy, succession, and gift taxes, or taxes reported elsewhere, such as in Schedule A.

Line 13
Interest

Include on line 13 only interest incurred in the trade or business activity(ies) of the corporation that is not claimed elsewhere on the return.

Do not include interest expense on debt used to purchase rental property or debt used in rental activities for which income or loss is reported on lines 2 and 3 of Schedule K.

Do not include interest expense which is clearly and directly allocable to gross income that is portfolio or investment income which is reported separately on line 11a of Schedule K.

Do not include interest on debt proceeds allocated to distributions made to shareholders during the tax year. Instead, report such interest on line 10 of Schedules K and K-1. To determine the amount to allocate to distributions to shareholders, see federal Notice 89-35, 1989-1, C.B. 675.

Do not include interest expenses on debt required to be allocated to the production of qualified property. Interest that is allocable to certain property produced by an S corporation for its own use or for sale must be capitalized. In addition, the corporation must also capitalize any interest on debt that is allocable to an asset used to produce the above property. A shareholder may have to capitalize interest that the shareholder incurs during the tax year with respect to the production expenditures of the S corporation. Similarly, interest incurred by an S corporation may have to be capitalized by a shareholder with respect to the shareholder's own production expenditures. The information required by the shareholder to properly capitalize interest for this purpose must be provided by the corporation in an attachment for line 22, of Schedule K-1. See IRC section 263A(f) and Internal Revenue Service Notice 88-89, 1988-36 I.R.B. 29, for additional information.

Federal temporary regulations section 1.163-8T gives rules for allocating interest expense among activities so that the passive activity limitation, investment interest limitation, and the personal interest limitation can be properly figured. Generally, interest expense is allocated in the same manner as debt is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. These regulations give rules for tracing debt proceeds to expenditures.

See federal temporary regulations section 1.163-8T for special rules on allocation of interest expense, transitional rules, and other details.

Generally, prepaid interest can only be deducted over the period to which the prepayment applies. See IRC section 461(g) for details.

Line 14
Depreciation

Enter depreciation expense from federal Form 4562 claimed on assets used in a trade or business activity.

Do not include any expense deduction for recovery property (IRC section 179) on this line. This amount is not deductible by the corporation. Instead, it is passed through to the shareholders on Schedules K and K-1, line 8.

Line 15
Depletion

If the corporation claims a deduction for timber depletion, complete and attach federal Form T, Forest Activities Schedules.

Do not report depletion deductions for oil and gas properties on this line. Each shareholder figures depletion on these properties under IRC section 613A(c)(13). See the instructions for federal Form 1120S, Schedule K-1, line 23, for information on oil and gas depletion that must be supplied to the shareholders by the corporation.

Line 18
Employee Benefit Programs

Enter the amount of contributions to employee benefit programs (such as insurance and health and welfare programs) that are not an incidental part of a pension, profit-sharing, etc., plan included in line 17.

See instructions for federal Form 1120S for more information.

Line 19
Other Deductions

Enter any other allowable deductions related to any trade or business activity for which there is no line on page 1 of the return. Do not include those items requiring separate computations which must be reported on Schedules K and K-1. Do not deduct losses incurred in transactions which were not connected with the corporation's trade or business. Report these losses separately to the shareholders on Schedules K and K-1, line 10.

Include in line 19 the deduction taken for amortization. See instructions for federal Form 4562 for more information.

In most cases, you may not take a deduction for any part of any item allocable to a class of exempt income. (See IRC section 265 for exceptions). Items directly attributable to wholly exempt income must be allocated to that income. Items directly attributable to any class of taxable income must be allocated to that taxable income.

If an item is indirectly attributable both to taxable income and to exempt income, allocate a reasonable proportion of the item to each, based on all the facts in each case.

Attach a statement showing (1) the amount of each class of exempt income and (2) the amount of expense items allocated to each such class. Show the amount allocated by apportionment separately.

The deductions for business meals and entertainment expenses are limited to 50%. Meal expenses are deductible only if the expenses are directly related or associated with the active conduct of a trade or business. In addition, the amount that may be deducted for entertainment tickets, skyboxes, or other private luxury boxes is limited. See federal Publication 463 for details.

Line 21
Ordinary Income (loss)

This is nonseparately computed income or loss as defined in IRC section 1366(a)(2). This income or loss is entered on Schedule K, line 1.

Line 21 income is not used in figuring line 22a or 22b tax. See instructions for line 22a for figuring taxable income for purposes of line 22a or 22b tax.

Line 22a

If the corporation has always been a subchapter S corporation, the line 22a tax does not apply.

S corporations that have accumulated earnings and profits at the end of the taxable year and passive investment income totaling over 25% of gross receipts are subject to a tax imposed at the rate of 6.4%. This tax is applied against the S corporation's excess net passive income.

To avoid double taxation, a special provision insures that any gain taken into account under IRC section 1375 in computing the tax on excess net passive income; but already taxed by IRC section 1374, may be used to reduce the amount of such passive income. Thus, only the resulting net amount shall be taxed.

Excess net passive income—

To calculate excess net passive income, multiply the corporation's net passive income for the year by a fraction, of which the numerator is the difference between the corporation's passive income for the period minus 25% of the gross receipts for that year. The denominator is the corporation's passive investment income for the same year.

Excess net passive income is defined by the following formula:

$$\text{ENPI} = \text{NPI} \times \frac{\text{P I} - (.25 \times \text{GR})}{\text{P I}}$$

Where:
ENPI= excess net passive income
NPI= net passive income
P I = passive investment income
GR= total gross receipts

Net passive income—

It means the corporation's passive investment income minus allowable deductions that are directly connected with the income. No deductions are allowed for the net operating losses (IRC section 172), organizational expenditures (IRC section 248) and the limitation on deduction of bond premium or repurchase (IRC section 249).

Line 22b

Refer to instructions for Schedule D.

Line 22c

Enter the number of N-4's attached to the corporation's return. On line 22c, enter the total amount of taxes withheld as shown on the Forms N-4 attached.

Line 23b

If the S corporation is a Hawaii corporation with an expected corporate tax liability of $500 or more, the corporation must file a declaration of estimated income tax and pay the estimated tax liability in four installments. See Form N-3 for more information. If the S corporation is not a Hawaii corporation and less than 15% of the corporation's business for the taxable year is attributed to Hawaii, the filing of an estimate and the payment of estimated tax may be excused upon application to the Department of Taxation.

Estimated taxes which are paid by the corporation on behalf of its nonresident shareholders in anticipation of the filing of a composite return should be made on Form N-1. See the instructions for filing composite returns later in these instructions for more information.

Any amount that was paid on an S corporation's Form N-3 for the tax year should be indicated in the N-3 space on line 23b and included in the line total.

If the corporation is not a Hawaii corporation and it sold any Hawaii real property and Hawaii State income taxes were withheld from the sales proceeds, the amount of tax so withheld, or the amount of tax remaining with the Department of Taxation if the corporation filed a Form N-288C, Application for Tentative Refund of Withholding on Dispositions by Nonresident Persons of Hawaii Real Property Interests, should be entered in the N-288 space on line 23b if the corporation is subject to Hawaii tax on the sale of property. If the sale of Hawaii property is not taxed at the corporate level, the amount of tax held by the Department is to be passed through to the shareholders on line 12k of Schedules K and K-1.

Line 24
Underpayment of Estimated Tax Penalty

A corporation that fails to make estimated tax payments when due may be subject to an underpayment penalty for the period of underpayment. Use Form N-220, Underpayment of Estimated Tax by Corporations, to see if the corporation owes a penalty and to figure the amount of the penalty.

Schedule A
Cost of Goods Sold

Inventory valuation methods

Your inventories can be valued at: (a) cost, (b) cost or market value (whichever is lower), or (c) any other method approved by the Director of Taxation, if that method conforms to the provisions of the applicable regulations cited below.

Taxpayers using erroneous valuation methods must change to a method permitted for Hawaii income tax purposes.

On line 9a, check the method(s) used for valuing inventories. Under "lower of cost or market," market generally applies to normal market conditions when there is a current bid price prevailing at the date the inventory is valued. When no regular open market exists or when quotations are nominal because of inactive market conditions, use fair market prices from the most reliable sales or purchase transactions that occurred near the date the inventory is valued. For additional requirements, see IRC Regulations section 1.471-4.

Inventory may be valued below cost when the merchandise is unsalable at normal prices or unusable in the normal way because the goods are "subnormal" (that is, because of damage, imperfections, show wear, etc.) within the meaning of IRC Regulations section 1.471-2(c). Such goods may be valued at a current bona fide selling price less direct cost of disposition (but not less than scrap value) when the taxpayer can establish such a price. See IRC Regulations section 1.471-2(c) for additional requirements.

If this is the first year the "Last-in First-out" (LIFO) inventory method was either adopted or extended to inventory goods not previously valued under the LIFO method, as provided in IRC section 472, attach a copy of **federal Form 970,** Application to Use LIFO Inventory Method, or a statement with Form N-35 and check the LIFO box on line 9b. On line 9c, enter the amount or percent (estimates may be used) of total closing inventories covered under IRC section 472.

If you have changed or extended your inventory method to LIFO and have had to "writeup" your opening inventory to cost in the year of election, report the effect of this writeup as income (line 5, page 1) proportionately over a 3-year period that begins in the tax year you made this election. (IRC section 472(d).)

If you are engaged in manufacturing or production, you must use the full absorption method of inventory costing. If you are not using it, you must change to this method. Under it, both direct and certain indirect production costs are included for inventory valuation purposes. Use federal Form 3115 to change to full absorption.

For more information, see IRC Regulations section 1.446-1(e)(3) and IRC Revenue Procedure 84-74, 1984-2 C.B. 738.

Schedule K and Schedule K-1
Shareholder's Share of Income, Credits, Deductions, etc.

Purpose

Schedule K is a summary schedule of all the shareholders' share of the corporation's income, deductions, credits, etc. and shows the amounts of these items that are attributable to Hawaii sources. Schedule K-1 shows each shareholder's distributive share. A copy of each shareholder's K-1 must be attached to the Form N-35 filed with the Department of Taxation. A copy is kept as a part of the corporation's records and each shareholder receives his or her own separate copy with attached instructions.

General Instructions

The corporation is liable for taxes on Form N-35, page 1, lines 22a and 22b. Resident shareholders are liable for income tax on their share of the corporation's total income (reduced by any taxes paid by the corporation on that income) and must include their share of the income on their tax return whether or not it is distributed to them. Nonresident shareholders are liable for Hawaii income tax on their share of the corporation's income attributable to Hawaii (reduced by any taxes paid by the corporation on that income). Part-year resident shareholders are liable for Hawaii income tax on their share of the corporation's total income while a resident plus Hawaii income tax on their share of the corporation's income attributable to Hawaii while a nonresident (reduced by any taxes paid by the corporation on those income amounts).

The total distributive share items (columns b and c) of all Schedules K-1 should equal the amount reported on Schedule K.

Attributable to Hawaii

Each S corporation must state specifically the income attributable to the State and income not attributable to the State with respect to each shareholder.

Ordinary income or (loss) from trade or business activities shall be attributed to the State by the use of the apportionment of business income allocation provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), section 235-29, HRS. Business income, including rent, capital gains, and portfolio income that appears on Schedule K, shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three. The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned or rented and used in this State during the tax period, and the denominator of which is the average value of all the corporation's real and tangible personal property owned or rented and used during the tax period. Property owned by the corporation is valued at its original cost. Property rented by the corporation is valued at eight times the net annual rental rate. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period. The use of monthly values may be required if necessary to properly reflect the average value of the corporation's property. The payroll factor is a fraction, the numerator of which is the total amount paid in this State during the tax period by the corporation for compensation, and the denominator of which is the total compensation paid everywhere during the tax period. The sales (gross receipts) factor is a fraction, the numerator of which is the total sales of the corporation in this State during the tax period, and the denominator of which is the total sales of the corporation everywhere during the tax period. If this apportionment does not fairly represent the extent of the corporation's business activity in this State, the corporation may request the use of separate accounting, the exclusion of one or more of the factors, the inclusion of one or more additional factors, or the use of any other method to accurately reflect the corporation's business activity in the State. Complete Schedules O and P on page 4 of Form N-35 to show this computation.

Non-business items are attributed as follows:

Net rents and royalties from real property located in Hawaii are attributed to Hawaii. Federal Form 8825 may be attached to Form N-35 as a schedule of expenses.

Net rents and royalties from tangible personal property are attributed to Hawaii if, and to the extent that, the property is utilized in Hawaii.

Capital gains and losses from sale of real property located in Hawaii are attributed to Hawaii.

Capital gains and losses from sales of tangible personal property are attributable to Hawaii if the property had a situs in Hawaii at the time of the sale.

Interest and dividends are attributed to Hawaii if the corporation's commercial domicile is in Hawaii.

Patent and copyright royalties are attributed to Hawaii if, and to the extent that, the patent or copyright is utilized by the payer in Hawaii. Amounts received by a qualified high technology business as royalties and other income derived from patents, copyrights, and trade secrets owned by the qualified high technology business and developed and arising out of a qualified high technology business are excluded from Hawaii income.

Shareholder's Distributive Share Items

Items of income, loss, deductions, etc., are allocated to a shareholder on a daily basis, according to the number of shares of stock held by the shareholder on each day during the tax year of the corporation. See Item A in the specific instructions below.

A transferee shareholder (rather than the transferor) is considered to be the owner of stock on the day it is transferred.

Special rule—If a shareholder terminates his or her interest in a corporation during the tax year, the corporation, with the concurrence of all affected shareholders, may elect to allocate income and expenses, etc., as if the corporation's tax year consisted of 2 tax years, the first which ends on the date of the shareholder's termination. To make the election, the corporation must file a statement of election with the return for the tax year of election and attach a statement of consent signed by all affected shareholders. If the election is made, write "IRC section 1377(a)(2) Election Made" at the top of each Schedule K-1. See IRC section 1377(a)(2) and IRC Regulations section 18.1377-1 for details and a definition of affected shareholders.

Specific Instructions

(Schedule K-1 only)

Prepare and give to each shareholder a Schedule K-1 on or before the day on which the corporation's return is filed. On each Schedule K-1, enter the names, addresses, and identifying numbers of the shareholder and corporation, complete items A through D and enter the shareholder's distributive share of each item.

Item A (Schedule K-1 only)

If there was no change in shareholders or in the relative interest in stock the shareholders owned during the tax year, enter the percentage of total stock owned by each shareholder during the tax year. For example, if shareholders X and Y each owned 50% for the entire tax year, enter 50% in item A for each shareholder. Each shareholder's distributive share items (lines 1-18 of Schedule K-1) are figured by multiplying the annual amount on Schedule K by the percentage in A.

If there was a change in stock ownership during the tax year, each shareholder's percentage of ownership is weighted for the number of days in the tax year that stock was owned. For example, A and B each held 50% for half the tax year and A, B, and C held 40%, 40% and 20% respectively for the remaining half of the tax year. The percentage of ownership for the year for A, B, and C is figured as follows and is then entered in item A.

	a.	b.	c. (a x b)	
	% of total	% of tax	% of ownership	
	stock owned	year held	for the year	
A	50%	50%	25%	
	40	50	+20	45%
B	50	50	25	
	40	50	+20	45%
C	20	50		10%
Total				100%

If there was a change in stock ownership during the tax year, each shareholder's distributive share items (lines 1-18 of Schedule K-1) are figured on a daily basis, based on the percentage of stock held by the shareholder on each day. See IRC section 1377(a)(1) and (2) for details.

Item B (Schedule K-1 only)

Enter the Taxation District Office address where the tax return, to which a copy of this K-1 was attached, was or will be filed. For example:

Oahu District Office, P.O. Box 3559, Honolulu, HI 96811-3559.

Schedules K and K-1

Lines 1 through 11

Refer to the instructions for federal Schedules K and K-1 (Form 1120S).

Enter the amount attributable to Hawaii and the amount attributable elsewhere for each applicable item listed.

Note: *Actual dividends distributions paid out of retained earnings (accumulated earnings and profits) of the S corporation are not reported on Schedule K-1. However, these dividends are reported to shareholders on federal Form 1099-DIV. These distributions do not increase or decrease a shareholder's basis in stock.*

Also note: All income received from stock acquired through stock options or warrants from a qualified high technology business by an investor who qualifies for the high technology business investment tax credit that would otherwise be taxed as ordinary income or as capital gains to those persons is exempt from taxation.

Line 12

Any S corporation doing business in Hawaii may qualify for Hawaii's Capital Goods Excise Tax Credit, the Credit for Employment of Vocational Rehabilitation Referrals, the Enterprise Zone Tax Credit, the Hawaii Tax Credit for Low-Income Housing, the Motion Picture and Film Production Income Tax Credit, the High Technology Business Investment Tax Credit, the Individual Development Account Contribution Tax Credit, the Hotel Construction and Remodeling Tax Credit, and the Tax Credit for Increasing Research Activities. Only S corporations organized under the laws of Hawaii, however, may also claim the Fuel Tax Credit for Commercial Fishers and the Credit for Energy Conservation. The benefits of these credits may be passed through to the shareholders of the corporation.

Report the shareholder's pro rata share of the applicable credits on Schedule K-1. For the Capital Goods Excise Tax Credit, report the cost of qualifying property, not the credit amount, on line 12b of Schedules K and K-1. For the Enterprise Zone Tax Credit, the S corporation is to prepare a separate Form N-756A for each shareholder. For the Motion Picture and Film Production Income Tax Credit, report the qualifying production costs and the qualifying transient accommodations costs, not the credit amounts, on lines 12g(1) and 12g(2), respectively, of Schedules K and K-1. Shareholders will compute their share of the credit on Form N-316. For the Credits for High Technology, report the pro rata credit amounts on line 12h(1) and 12h(2) of Schedules K and K-1. Shareholders, will compute their credits on Form N-318. Report the pro rata credit amount for the Individual Development Account Contribution Tax Credit on line 12i. Shareholders will compute their credit on Form N-320. For the Hotel Construction and Remodeling Tax Credit, report the pro rata credit amount on line 12j. Attach a copy of Form N-314 to the S corporation's return. Shareholders will also use this form to claim their chare of the credit.

Line 12k

Enter the amount of Hawaii taxes held by the Department of Taxation from the sale of Hawaii real property that is not taxed at the corporate level.

Lines 13 through 18

Refer to the instructions for federal Schedule K (Form 1120S).

Amounts paid to shareholders who are residents of Hawaii are to be entered in columns b and c. Amounts paid to shareholders who are not residents of Hawaii are to be entered in column b.

Schedules L, M-1, and M-2 (Form N-35)

Attach a copy of page 4 of federal Form 1120S to the corporation's Hawaii return. The corporation must also maintain a State Accumulated Adjustments Account.

Schedule NS, Hawaii S Corporation Agreement of Nonresident Shareholders

S corporations having nonresident shareholders are required to obtain from each nonresident shareholder, and file with the Department, an agreement that the shareholder will file a Hawaii return and make timely payment of all taxes imposed with respect to the shareholder's share of the S corporation's Hawaii income. Also, the shareholder will be subject to personal jurisdiction in the State for purposes of the collection of unpaid income tax, penalties, and interest. Schedule NS is used for this purpose. If the corporation fails to timely file these agreements on behalf of its nonresident shareholders, the corporation is required to pay to the State, on behalf of each shareholder for whom an agreement has not been timely filed, an amount equal to the highest marginal tax rate on individuals, currently 8.75%, multiplied by the shareholder's pro rata share of the income attributable to the State (lines 1 through 6, column b, of the shareholder's Schedule K-1). Form N-4 is used for reporting this withholding by the corporation to the Department. The nonresident shareholder is notified of the amount withheld on Schedule K-1, line 12l. Any payments so made will be considered to be a payment by the shareholder on account of the income tax imposed on the shareholder for the taxable period. The corporation is entitled to recover a payment from the shareholder on whose behalf the payment was made. These agreements are to be filed with the corporation's return for the first period for which the corporation is subject to this provision and for any period in which the corporation had a nonresident shareholder on whose behalf such an agreement has not been previously filed. A shareholder may revoke, in writing, an agreement previously made. The revocation will be effective for the year of the corporation's return to which the statement of revocation is attached and subsequent years, thereby subjecting the shareholder to the withholding provisions. The revocation cannot be made retroactive.

Form N-4, Statement of Withholding for a Nonresident Shareholder of an S Corporation

Form N-4 is to be completed for each nonresident shareholder for whom a Schedule NS has not been filed on a timely filed N-35 and for nonresident shareholders who have revoked a previously filed Schedule NS. In box 1, fill in the S corporation's full name and mailing address. Show the shareholder's social security number or other tax identification number in box 2. Enter the amount of Hawaii tax that was withheld for the nonresident shareholder in box 3 (8.75% of the amount shown in box 6). Show the S corporation's Federal Employer's Identification Number (FEIN) in box 4. Enter the shareholder's name and complete mailing address in box 5. In box 6, enter the shareholder's share of the S corporation's income attributable to Hawaii, the sum of lines 1 through 6 of the shareholder's Schedule K-1. Attach Copy A of Form N-4 to the S corporation's Form N-35. Retain Copy B for the corporation's records. Copy C is for the shareholders' records.

Composite Returns for Nonresident Shareholders

S corporations may file composite returns on behalf of some or all of its nonresident shareholders. In order to be included in a composite return, the shareholder must be an individual, the shareholder must have a signed Schedule NS in effect, and the shareholder's only Hawaii source of income is from the S corporation.

The corporation must obtain a statement from each nonresident shareholder electing to be included in the composite return stating that the shareholder elects to be included in the return, that the income of the S corporation attributable to Hawaii is the shareholder's only Hawaii income, and the shareholder is not otherwise required to file a Hawaii income tax return. The corporation must also get a power of attorney from the shareholder for the purpose of filing the return. These statements should be retained by the corporation.

Once a shareholder elects to be part of a composite return, the shareholder cannot elect out of the return for that year unless other Hawaii source income is received by the shareholder. If this occurs, the shareholder must notify the corporation and the corporation must amend the composite return to remove the shareholder from the return. The shareholder must then file his or her own Hawaii nonresident return, Form N-15.

The composite return for nonresident shareholders is to be filed on Form N-15, Individual Income Tax Return Nonresident and Part-Year Resident. The first name on the composite return shall be "Shareholders", the last name shall be the corporation's name. The corporation's FEIN with a suffix "S" shall be used in place of the taxpayer's social security number. Indicate the corporation's mailing address as the taxpayer's address. Do NOT indicate filing status or number of exemptions. On line 17, Column A of Form N-15, enter the total distributive share of the corporation's total income and on line 17, Column B the total of Hawaii income for the shareholders included in the return. Enter these same amounts on line 33 and the Hawaii amount also on line 34. On line 40, enter the total of the shareholders' taxable incomes; on line 41, enter the total amount of tax on the taxable incomes entered on line 40, including the total amount of other taxes from Forms N-152, N-312, N-405, N-586, and N-814. The amount on line 41 should be the sum of the tax computed for each of the individual shareholders included on the return. Any Hawaii credits available to the included shareholders should be claimed on the return. Any tax due on the return, line 57, is to be paid by the corporation on behalf of the shareholders. Overpayments (line 54), if any (if not applied to estimated taxes for the subsequent year (line 56)), will be refunded (line 55) to the corporation which will make the refund distribution to the shareholders. The return is to be signed by the Tax Matters Person.

Attach to the return a schedule listing the names, addresses, social security numbers, the filing status, the distributive share of Hawaii income or (loss), the individual shareholder's allowable itemized deductions, each shareholder's Hawaii taxable income, the tax due computed on the taxable income of the individual shareholders, credits if applicable, and the tax due or overpayments for each of the shareholders included in the return.

Filing status may be indicated by the following codes: S - single, MJ - married filing a joint return, MS - married filing separately, HH - head of household, and QW - qualifying widow(er) with dependent child.

The individual shareholder's taxable income is computed by subtracting allowable itemized deductions from the shareholder's distributive share of the corporation's income. Allowable itemized deductions are those allowed for Hawaii income tax purposes which are not determined by using the ratio of Hawaii adjusted gross income to total gross income. No standard deduction is allowed.

Nonresident shareholders who have made Hawaii estimated tax payments during the 2000 tax year and are allowed to be included on the composite return may have those payments credited to the composite return. The S corporation may claim these payments on Form N-15, line 45, by entering the total of the estimated tax payments along with "see attached schedule" in the amount column of line 45 and attaching a schedule of the estimated tax payments by stating each individual's name, address, social security number, and each type of estimated payment and amount of payment (e.g., N-1, 1st quarter - $200; N-1, 2nd quarter - $300, etc.) made by the individual.

If it is expected that there will be taxes due on the composite return, estimated taxes may be paid for the composite return using Form N-1.

If an extension is needed for the composite return, an application may be made on Form N-101A or on federal Form 4868. If federal Form 4868 is used, it must be completed using amounts for Hawaii income tax purposes. The extension of a composite return will not serve to extend the separate return of a shareholder.